DOW THEORY LETTERS INC.

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36 Letters per Year — $75 Annually

Registered with the Securities Exchange Commission

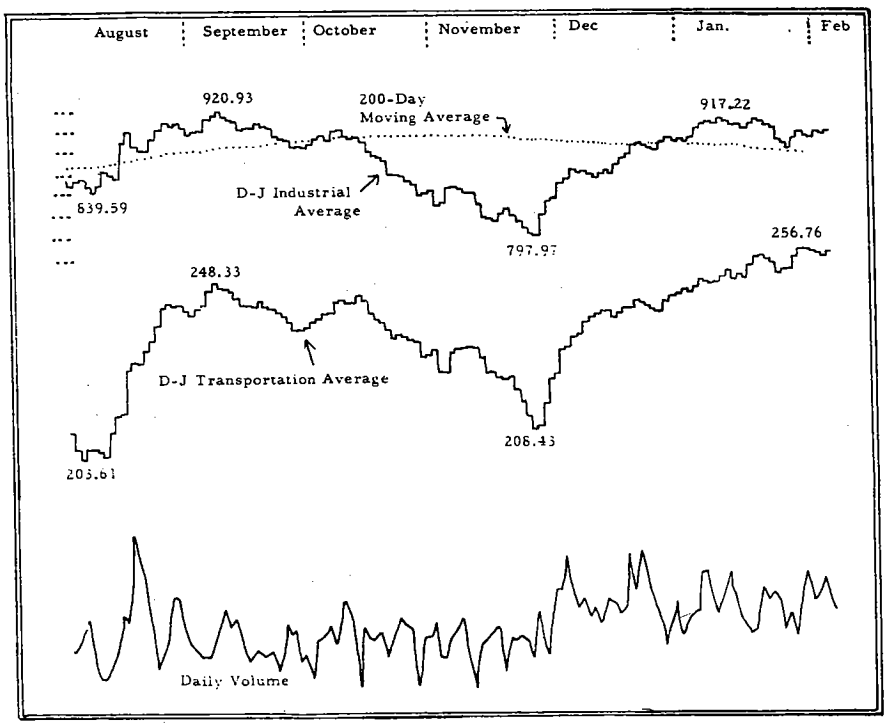
February 9, 1972 Letter 520

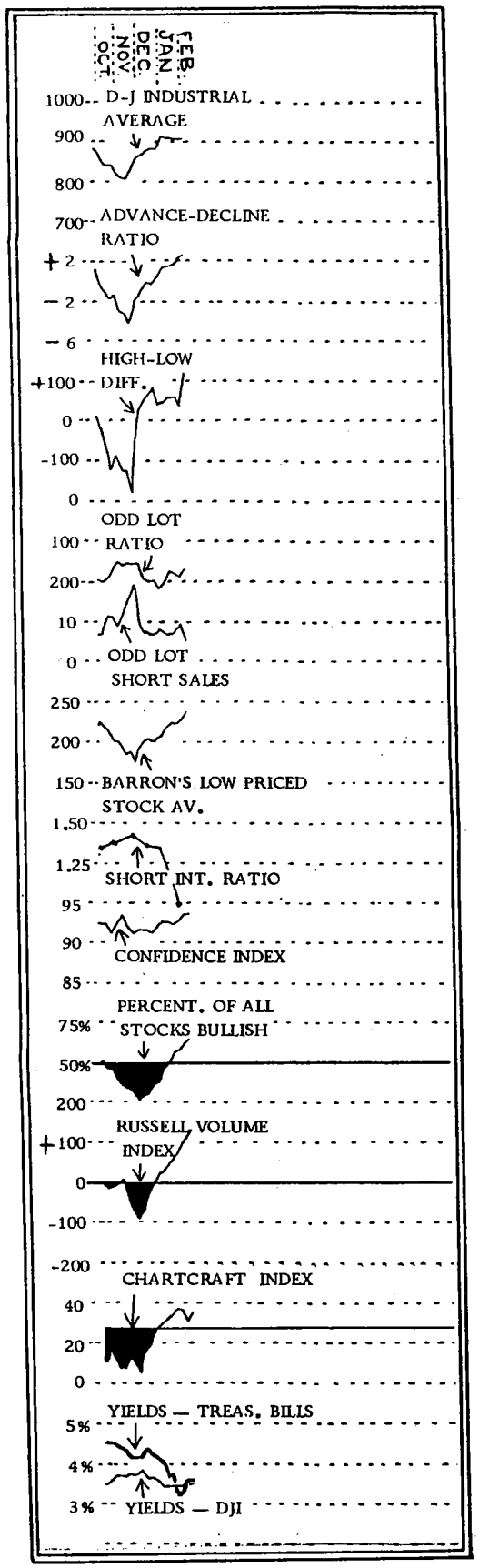
THE PICTURE: I have been saying it all along, and I believe it is now beginning to happen. The rest of the Free World has been in a massive poker game, and they are waking up to find (to their horror) that the banker has been playing with phoney chips. The banker (the U.S., of course) has been passing out billions of chips which are flooding the coffers of the Free World, but those chips can't be converted into real value (gold), and equally frightening the chips continue to flood the market. Almost daily, the (former) banker's chips are worth less, sinking in value, and the rest of the players are starting to panic. They are beginning to trade their chips in for whatever they can get, and they are passing them on to anyone who will take them.

One of the places the chips are going is the gold bullion market, and the London gold price has been soaring because of this (see page 6 chart). A second place is the New York Stock Exchange, and here we have huge churning action as millions of shares are being exchanged with little change in price (see chart on this page).

In the face of the critical situation outlined above, Europe knows that with sky-rocketing budget deficits, the U.S. will need to finance those deficits in coming months. This means an even more fantastic expansion of the money supply and also climbing interest rates. The bond markets are starting to sag because of this, and the Utility Average is heading down. Mr. Nixon's rickety Phase II is proving a failure, and last week the 35 million member Consumer Federation of America denounced Phase II as a flop (see page 2 news clip).

Finally, Mr. Connally, perhaps smelling something which may resemble the aroma of ripening Limburger, is rumored to be "leaving the ship" (see page 2 news clip) in favor of the wide open spaces of his native Texas. If true, this could turn out to be the wisest move our Secretary of the Treasury has made all year.





On Wall Street it is requiring the greatest volume in N.Y.S.E. history to move this market up. In 1968, for the first time in a single year, we had three days of over 20 million shares on the Big Board. In 1969, we had none, The year 1970 produced five over-20 million share days. In 1971, we saw twenty-eight days of over 20-million shares. And in 1972, we have had eight over-20 million share days already, seven of them in January alone. Thus volume is at frenzied levels, and all this is occurring with the three D-J Averages (Industrials, Transports and Utilities) below their previous highs.

Is Secretary of the Treasury John Connally, the Texas Democrat, thinking of leaving the Nixon Cabinet? His brother Wayne, a candidate for Lieutenant Governor in Texas, reportedly is convinced the Secretary will resign and return to his home State before the November election.

Actually, if you study the page 1 chart you will notice that the current huge volume is occurring with Industrials below their September, 1971, highs and with Transports slightly above their own September peaks. Therefore, it may be said that over the last five months a massive amount of fuel has been burned up under the market boiler without any appreciable "lift" in prices.

Furthermore, the non-confirmation which I have been drawing attention to in the last few Letters is still much in evidence, with Industrials (so far) refusing to better their high of five months ago (the September 8 peak of 920.93) even though Transports have bettered their own September 7 peak (248.33) by a few points.

In other words, we now have the highly dangerous picture of a major non-confirmation, record-breaking volume, a relatively weak Industrial Average and broad participation by many of the "junk" and "cats-and-dogs" issues on the New York, Amex and other exchanges. In general, I would say that any time the blue-chip Dow Industrials turn weak while the speculative issues blow up a storm — watch out. Investment money is leaving while the crap shooters are coming in. This is the formula for trouble, and I have seen it happen on many occasions.

A great deal is now being made of the superior strength in the more "broadly-based" averages as compared with the D-J Industrial Average. I am reminded of late-1968, at which time the broadly-based averages rose to new highs, although the Dow Industrials steadfastly refused to better its 1966 bull market high. The aftermath of this "lag" in the Dow (I termed it a highly dangerous non-confirmation) was one of the most vicious collapses in modern stock market annals.

Consumer Unit Says Economy Controls Fail

WASHINGTON (UPI) — The Consumer Federation of America denounced President Nixon's economic controls as a failure yesterday.

The 35-million-member federation, a coalition of 192 organizations interested in consumer affairs, adopted a resolution at the close of its fifth annual meeting accusing the administration of "stringent restrictions on wage increases and (allowing) prices and profits to increase virtually without restraint."

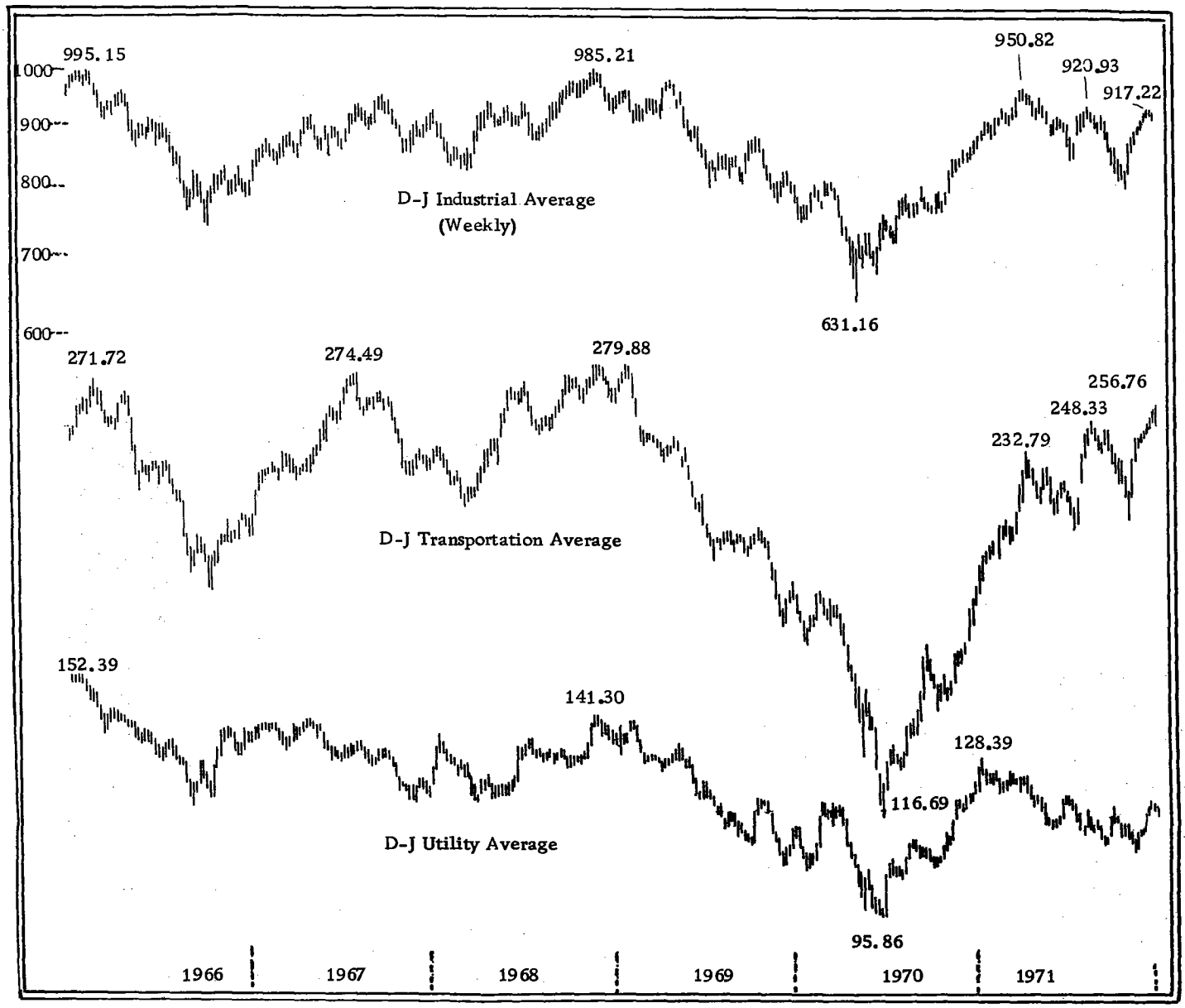
Therefore, at this time it might be well to ponder the rationale of an Average of 30 of America's largest and most important corporations which refuses to better its peak of 10 months ago (April, 1971, peak of 950.82) or even its high of one month ago (January, 1972, peak of 917.28). I would say that the greater the time-lag and the higher the volume in the face of a possible failure to better the peaks just designated, the more dangerous the entire market situation.

I might also mention that almost daily some "leading" broker or analyst bursts into print with a promise and prediction that the Dow will "break 1000" in 1972. The game has now reduced itself to a matter, not of whether but of when, with each crystal-ball gazer picking his favorite month. If it's fearless forcasters that are needed, Wall Street was never in better shape.

PRICE STRUCTURE: The page 3 chart shows the three D-J common stock Averages (weekly) from 1966 to the present. The chart is drawn to ratio (semi-logarithmic) scale, so that all movements are shown in percentages. Thus a move from 100 to 150 on Utilities will cover the exact vertical distance on the chart as a rise from 500 to 750 on the Industrial Average. In each case, the movement would represent a 50% advance.

But it is the structure of the Averages which fascinates me at present. Note that since 1966 the Industrial Average has formed a series of three descending tops, 995.15 (1966), 985.21 (1968), and 950.82 (1971). Meanwhile, the Transports during 1966-68 have formed a series of three ascending peaks, 271.72 (1966), 274.49 (1967 and 279.88 (1968). The 1966-68 divergence in the two Averages flashed clear (but generally disregarded) warning signals, and this preceded the collapse of 1969-70, a smash which was the worst since 1937.

Now the incredible thing is that since 1970 (see chart) we have been forming a sort of smaller "repeat" of the 1966-70 divergence. Note that since April, 1971, the Transports have again traced out a series of ascending peaks (232.79, 248.33 and 256.76) while during the same period the Industrials have formed a series of three descending peaks (950.82, 930.92 and 917.22). Thus we have the absolutely extraordinary picture of a long-term divergence developing during the years 1966 to 1968 and a smaller "copy" of that divergence being traced out during 1971 and 1972.



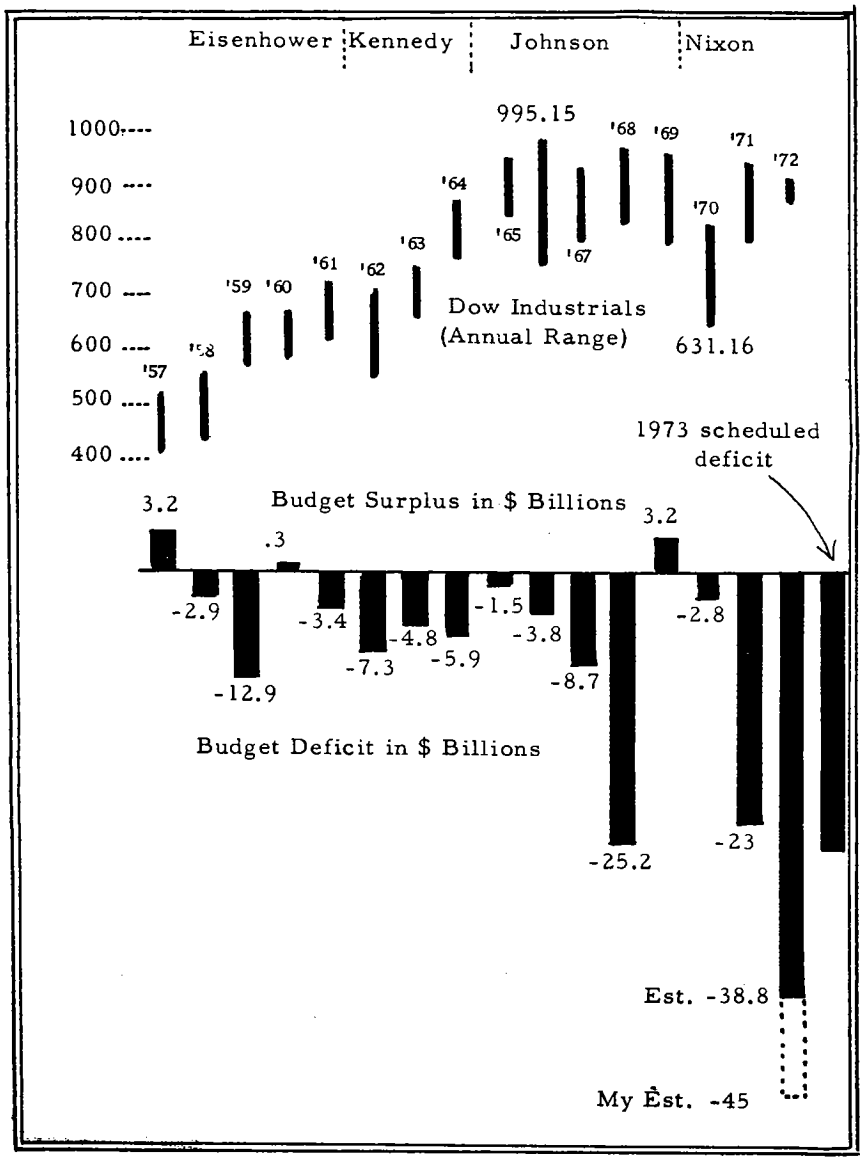
And as background for this entire picture we have a seven year downtrend in the Utility Average (which often acts as a bellwether for the rest of the market), starting with the 1965 peak of 163.32, then the 1966 high of 152.39, the 1968 high of 141.30 and finally the 1970 top of 128.39.

Thus, the primary bear market which began in February, 1966, has taken a most unorthodox course. As I see it, the bear market has been subtle and deceptive, but as outlined above it has left its (very sophisticated) "danger signals and signs" for serious stock market students to uncover. I feel that without the relentless Government manipulation, the bear market which began in 1966 would probably now be over. As it is, what we have is a nation on the verge of bankruptcy, a currency nobody trusts, an economy which depends on a mammoth defense industry for its "prosperity", and a country which has espoused the philosophy of debt-building so tightly that it is shaking the economic foundations of the Free World.

I have always felt that if one could decipher the story being told by the Averages, he would literally be able to unlock the deepest secrets of the economic, social and political structure of the nation. The amazing series of divergences which have developed in the Averages since 1966 are to my mind, unique in the history of the stock market. Divergences in a high area, following a major rise (such as 1949 to 1966) have, in past history, been the signals for trouble ahead. This has been proved by the Dow Theory over and over again. As a Dow Theorist, I feel it my duty to point to the danger signals now. To my knowledge, this Letter represents the first instance in which the "double series of divergence" has been revealed to the stock market student. I expect many other advisory services to pick up and repeat what they read here (and they usually do give me credit for it). They are welcome to do so, and if my observations serve as a timely warning to serious stock market students, I feel that I will have done my duty.

DESPERATION: "The American Government's budget-estimating process is approaching the state of a joke, or perhaps a scandal." (From the London Economist, January 29, 1972).

Last week I decided to draw what I thought would be an interesting chart, a comparison that I had never seen before. This is the annual high-low for the Dow Industrials superimposed upon the surplus or deficit for the Federal budget. The results are shown, and I must say they were rather fascinating. ("Ghastly" rather than fascinating is the word used by people I have shown this chart to).



At any rate, here we see the record of the Federal budget surpluses or deficits through four Presidencies, from Eisenhower to Nixon. During this period the Dow Industrials went through the third phase (i.e. 1957-66) of the 1949-66 bull market, rising from 419 (1957) to 995 (1966). At the 995.15 top of February, 1966, a primary bear market took over, and this occurred during Mr. Johnson's term of office.

Mr. Eisenhower and Mr. Kennedy had each managed to produce a single miniscule budget surplus, and during fiscal 1969 Nixon produced another little budget surplus. That's the extent of it. All the rest is red ink.

Now look what happened after the bear market started in 1966. Here the Administrations were faced with two major problems: (1) The main direction of business was down, since the bear had taken over. This, the Presidents wanted to counteract, and to do this they had to spend, spend, spend. (2) The trend of corporate profits were down. This meant that while Government spending sent the deficits up, falling tax receipts sent them up even further. The river of red ink during Mr. Johnson's and Mr. Nixon's early Administrations turned into an ocean of red ink.

Following a $23 billion deficit in 1971, the current year's deficit promises to come near $50 billion, with a scheduled $25 billion for fiscal 1973 (this estimate is undoubtedly far below what the final figure will be). Thus, Mr. Nixon shows a good chance of running a three year total deficit of perhaps $100 billion!

To my mind, the whole thing is approaching disastrous proportions, and I believe that the problem of financing the 1972 budget fiasco is going to stop any incipient business expansion dead in its tracks. I agree with economist Eliot Janeway, when he states (in his most recent report): "In clarifying my sharpening argument with the bulls on business, it is appropriate to repeat that I expect the first quarter (for business) to stand as the high point of the calendar year." Later in his report he writes, "My judgment is that a surge in Federal spending will not save the economic situation, but that it will wreck the financial markets." Finally, Janeway very correctly notes that a big portion of the current deficit "directly measures the slippage in tax collections due to the squeeze on earnings."

In the face of the on-coming budget horror, the Administration has asked for a $50 billion increase in the U.S. debt ceiling to $480 billion, the biggest increase since World War II.

To gain some insight into what has occurred, it is well to note that the gross Federal debt has risen 51% from the end of 1954 to the end of 1971 — to $409 billion, and through 1973 it will increase to $493 billion. Obviously, this sort of fiscal insanity cannot continue, and already the writing is on the wall.

The fact is that our foreign creditors are panicking. Ordinarily, when a major currency is devalued or other currencies are revalued against it, that major currency is the strongest currency in the world for many months if not years. But the dollar, following realignments by other currencies, is already tottering (one month after Mr. Nixon's "victory"), and the price of gold (which is a measure of man's instinct for fiscal survival) is marching relentlessly higher. Foreign currencies should be rushing into dollars. Instead, they are sitting tight or moving into gold.

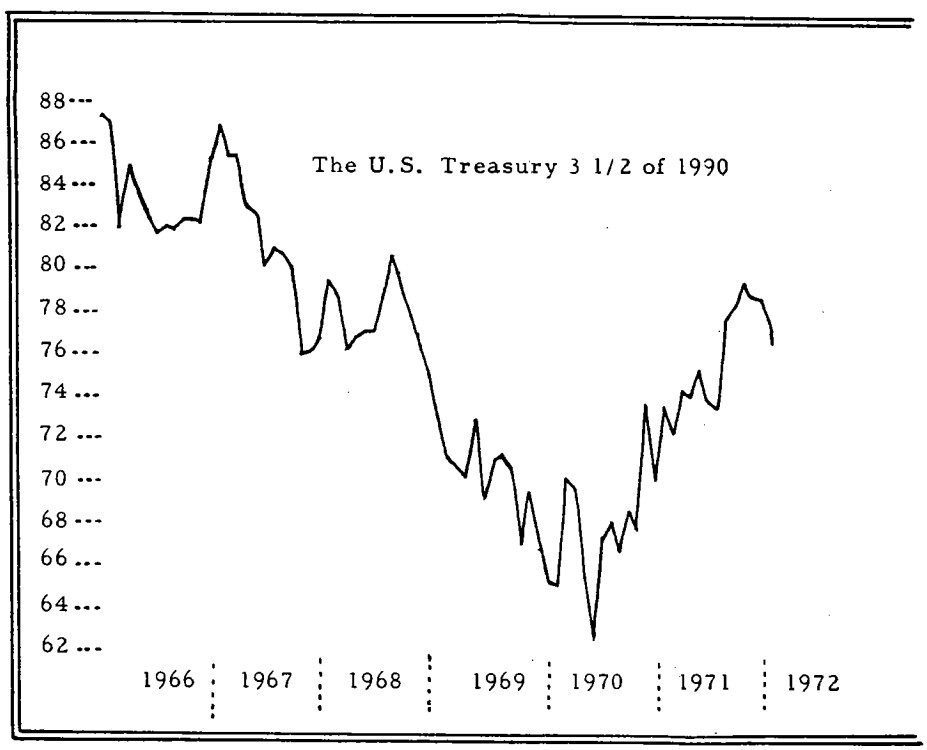
As I look at the accompanying chart I wonder what will happen when business turns down, and the primary bear market smothers all in its final remorseless plunge. Obviously, the gigantic debt generated in recent years is going to strangle what is left of the U.S. financial structure, and a new and even more unbelievable budget deficit may be scheduled in a frantic attempt to "beat the primary bear trend". But I ask myself as I study this chart, "If the deficits shown here can't put the Dow through 1000, what are the men in Washington thinking of? Do they really think new deficits and new rounds of spending are going to do any better? Or is the story being told now, so that all who have eyes can see?" I'm very much afraid that it is, and the ending is anyone's guess. But this I know. The final unwinding won't be easy, and it won't be painless. For budget deficits, like heroin, leave one no choice but the ultimate agony of "getting off" or the ultimate pain of death.

BONDS: In my last Letter I wrote about Government bonds and the 4¼ of 1987-92. I received many letters and questions about these bonds, so I will amplify a little further. I have charted another Government bond in this Letter, the U.S. Treasury 3½ of 1990. This bond, backed by the full power of the U.S. Government, is now selling at a deep discount of under 77 (under $770) although the bond was originally issued at 100 ($1000) to yield $35 per year, paid semi-annually, on its 3.5% coupon.

Since bonds always adjust themselves to the current rate of interest, the 3.5% bond of 1990 is now selling under 77 to yield about 5.5%. This yield puts the bond roughly in line with today's market. However, there is a very interesting feature of this deep-discount bond. If you buy the bond now, and interest rates never get back to 3.5%, you may be in position to have to sit with this bond for 18 years or until the bond reaches maturity (at which time the U.S. Government will pay you the maturity price of $1000). That would mean that you were collecting $35 per year from here on plus a capital gain of $240 per bond at maturity.

However, suppose the economy caves in, business slumps, and ultimately (as has happened during other depressions) interest rates collapse. If that occurs, and for the sake of argument Treasury bond interest rates decline to say 3.5% by 1975, then the 3.5% bond of 1990 would sell for about $1000 or in line with general interest rates by 1975. If so, the buyer would be getting his 5.5% return based on today's market, plus a gain of $260 over three years or about $85 per year for each of the three years. This would amount to about 11% gain (capital gain) for each of the three years plus the 5.5% rate of interest.

All of which means that the bonds contain only one risk on the downside, and that risk is that the purchaser will get locked in if interest rates rise — and he may need his money before the bond matures. So, do not buy discounted bonds unless you are reasonably sure that you will not need the money before the bonds mature. But if you can spare the money, discounted Treasury bonds are one of the safest and wisest investments I know of.



THOUGHTS AND OBSERVATIONS: Much has been said about the high cost of doing business in the U.S. Many are saying that the U.S. will be a "service economy" and that other nations (who can do it cheaper) will do the producing. It's not going to work out that

way. And I can state that in order to make money, a nation ultimately has to produce something that people need. You can't run a country with half of the people selling hamburgers to the other half and the other half selling life insurance to the hamburger sellers.

All of which brings me to this little clip which is very funny but also not so funny. After all, there are still alot of cattle in the U.S., but I guess Merrill Lynch's ad agency is just as cost-conscious as everybody else.

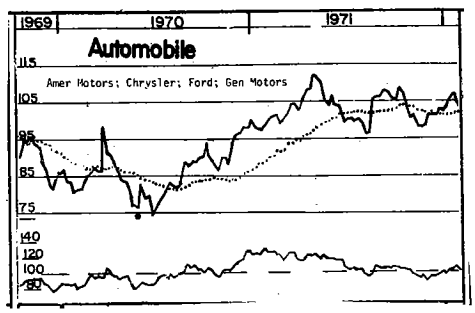
BULL Merrill Lynch Pierce Fenner & Smith, largest stock brokerage in the nation, sponsors a television commercial in which bulls are shown roaring along the prairie while the announcer proudly and resonantly declares:

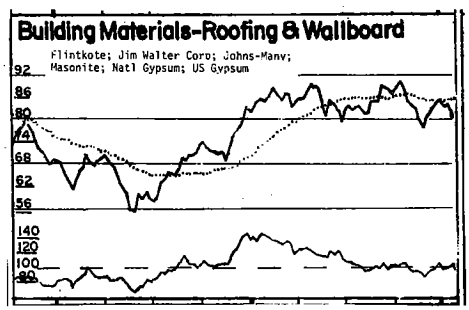
"Merrill Lynch is bullish on America...we see America growing in many different ways...at Merrill Lynch we are bullish on America."

So bullish in fact that they shot the TV commercial in Durango, Mexico.

San Diego will be the site of the Republican convention this year, and now the area which I have lauded to my subscribers for the past 10 years will be under national inspection. Actually, San Diego has passed San Francisco in population, and San Diego needs little touting these days. However, for sheer excellent of living, I want again to recommend it to any of my subscribers who are getting tired of the East, the North, the South or any other spot on the globe. San Diego offers the world's finest weather, outdoor living the year round, top medical facilities, proximity to a foreign country (Mexico), proximity to the desert, the ocean and the mountains. Furthermore, prices here are cheap compared with most other comparable areas of the nation. San Diego is a good place to live (I hesitate to say retire, because I don't approve of retiring. I approve of leaving what you're doing for something more interesting, even if it is only meditating, but that, to my mind, is not retiring, it's coming alive.

GROUPS: I am including two group charts from Jim Dines' Paflibe Chartbook (18 E. 41st St., N.Y.C. 10017). These two groups are most interesting, since they are two which are most named as the potential mainstay of the "coming boom". Neither of the two groups look strong on the chart, and I might add that the lower lines on the charts are the 30-week momentum indices (the ratio of the price today compared with the price 30 weeks ago).





STOCKS: Again from Paflibe, I am including part of the point and figure section of S. African gold charts. I feel that all of the stocks depicted on this section are "basing" and "backing and filling" preparatory to major moves on the upside. Most of these shares (with the exception of Western Holdings) are in low areas where they may be accumulated and held for the longer term, and most of them pay handsome dividends so the waiting should be no hardship. So far, the gold shares have gathered little or no following on Wall Street, and this is as it should be. When they do get a following, they will probably be one-half to two-thirds the way towards the ultimate peaks.